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MINUTES ECONOMIC POLICY COUNCIL

August 1, 1985 11:00 a.m. Cabinet Room

Attendees:

The President, The Vice President, Messrs. Baker, Weinberger, Block, Baldrige, Regan, Yeutter, Sprinkel, Whitehead, Ford, Wright, Kingon, McAllister, Buchanan, Friedersdorf, Oglesby, Speakes, Thompson, Naylor, Chew, Dawson, Hobbs, Khedouri and Niehenke, and Ms. Dole.

1. The Farm Bill

Secretary Block stated that the economic conditions under which the farm bill is being drafted are dismal: exports are down 25 percent; interest rates for many farmers are increasing; farm prices are low; one-half of farmers are losing money; and one-third are sliding toward insolvency. He explained that Congress's primary intention in drafting the farm bill is to maintain farm income. However, to expand farm exports, another important objective, prices must come down. The only way to meet the two objectives is to significantly increase Federal spending on agricultural programs.

Assistant Secretary Thompson traced the origins of the current agricultural problems to the 1970s. During the 70s farming prospered because markets abroad were growing. Rising farm prices and the expectation of continued general inflation prompted increased investment in machinery and equipment and real estate. The changing macroeconomic conditions of the 1980s -- the rising value of the dollar, rising interest rates, and declining inflation -- have dampened the demand for U.S. agricultural products abroad and increased the cost of land and capital. As a result of the resulting squeeze on earnings, 53 percent of farms in 1984 had negative cash flow. Farmers in the Corn Belt, Lake States and Northern Plains, in particular, are facing severe cash flow difficulties.

Secretary Block illustrated the expansion in the farm bill by pointing out that the Administration's farm bill proposed spending of \$22 billion, the Senate Budget Resolution provided for \$32 billion, and the Senate and House agriculture committees are working on bills that would cost over \$50 billion. He stated that the Economic Policy Council has identified several unacceptable provisions for a farm bill, including mandatory supply control, marketing loans, a dairy diversion program, a simple extension of current law, and the establishment of price or income supports.

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Minutes Economic Policy Council August 1, 1985 Page two

Secretary Block stated that the Administration should seek to reduce income supports, delete authority for market loans, delete the dairy diversion provision, and reduce dairy supports. He asked the President for a meeting of the Legislative Strategy Group to develop an approach to highlighting the Administration's opposition to the costly elements of the farm bills being drafted and developing a strategic approach for dealing with Congress.

The Council also discussed with the President a number of conceptual approaches to reducing the Federal Government's influence on agricultural economic decisions.

2. Agricultural Credit Policy

Undersecretary Naylor reported that the agricultural credit situation mirrors the farm income situation. He explained that the Federal Government has a large stake in the deteriorating credit situation through the exposure of the Farmers Home Administration (FmHA), a government agency, and the Farm Credit System (FCS), a privately owned, but Federally sponsored farm lender. The FmHA is becoming a lender of last resort, as commercial banks and the FCS are turning away borrowers, who are then turning to the FmHA for operating loans, which enable the borrower to use his other resources to meet real estate debt expenses. These loans are becoming "entitlements" as several court rulings have inhibited the FmHA's ability to foreclose on delinquent loans. He estimated that \$8.5 billion, one-third of FmHA portfolio, is uncollectable.

Mr. Naylor reported that although the FCS is in good overall fiscal condition there are district banks that are in trouble, the most serious of which is the Omaha district bank. The FCS has two impediments to addressing its regional problems: (1) the system is highly decentralized and operates on a consensus basis. Because the FCS's equity is spread among 900 separate entities, and these entities are required to share losses only if there is a technical default, districts cannot easily draw on the resources of other districts; and (2) the Farm Credit Administration (FCA), which supervises the FCS, lacks the regulatory and enforcement powers to require acceptable credit standards.

Mr. Naylor outlined the four options developed by the Economic Policy Council:

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1. Limit FmHA direct lending to servicing its existing portfolio. Eliminate FmHA real estate lending. Limit FmHA to guaranteeing new operating loans up to a maximum of 70 percent.

Encourage the FCS to solve its problems without Federal aid or interference.

2. Limit FmHA direct lending to servicing its existing portfolio. Limit FmHA real estate lending to current levels. Continue FmHA guaranteeing new operating loans up to a maximum of 90 percent.

Encourage the FCS to solve its problems without Federal aid or interference.

3. Limit FmHA direct lending to servicing its existing portfolio. Eliminate FmHA real estate lending. Limit FmHA guaranteeing new operating loans up to a maximum of 70 percent.

Require the FCS to utilize its internal resources, restructure the FCA to provide it strong regulatory and enforcement powers and establish an insured fund. In exchange, the Federal Government would provide a line of credit or direct Federal financing for the FCS.

4. Limit FmHA direct lending to servicing its existing portfolio. Eliminate FmHA real estate lending. Limit FmHA guaranteeing new operating loans up to a maximum of 70 percent.

Require the FCS to utilize its internal resources and restructure the FCA to provide it strong regulatory and enforcement powers and establish an insured fund. In exchange, the Federal Government would consider creating a Federally-chartered, privately-owned credit institution (Aggie Mae) to purchase nonperforming loans.

Mr. Naylor stated that the Economic Policy Council unanimously recommends option 2, which can be implemented with existing authorities.

Secretary Baker stressed that the Administration should emphasize that the FCS is in good fiscal health and that we are confident that it has the resources to address its own problems, now and in the future.

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Decision

The President accepted the Economic Policy Council's recommendation and adopted option 2.

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THE WHITE HOUSE WASHINGTON

July 31, 1985

NOTE FOR WILLIAM J. CASEY

FROM: ROGER B. PORTER

The agenda and papers for the August 1 Meeting of the Economic Policy Council are attached.



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THE WHITE HOUSE

WASHINGTON

July 31, 1985

MEMORANDUM FOR THE ECONOMIC POLICY COUNCIL

FROM:

ROGER B. PORTER

SUBJECT:

Agenda and Papers for the August 1 Meeting

The agenda and papers for the August 1 meeting of the Economic Policy Council are attached. The meeting is scheduled for 11:00 a.m. in the Cabinet Room.

The first agenda item is an update on farm conditions and the status of the 1985 farm bill. A paper describing the environment in which the farm bill is being drafted and how that environment is affecting the farm bill is attached.

The second agenda item concerns current farm credit conditions. The Economic Policy Council has reviewed the causes and effects of the current agricultural credit problems and outlined several options for dealing with the problems. A paper describing the extent and cause of the problems and outlining specific options with regard to the Farmers Home Administration (FmHA) and the Farm Credit System (FCS) is attached.

Attachments

THE WHITE HOUSE

WASHINGTON

ECONOMIC POLICY COUNCIL

11:00 a.m.

The Cabinet Room

AGENDA

- 1. The Farm Bill
- 2. Farm Credit Conditions

THE WHITE HOUSE

WASHINGTON

July 31, 1985

MEMORANDUM FOR THE PRESIDENT

FROM:

ECONOMIC POLICY COUNCIL

SUBJECT:

Current Economic Conditions in the Agricultural

Sector and the 1985 Farm Bill

The Economic Policy Council recently met to review the current economic conditions in the agricultural sector and to discuss the current progress of the 1985 Farm Bill. The following provides an overview of the environment in which the Farm Bill is currently being drafted and reviews the status of Farm Bill deliberations in the Congress.

CURRENT ECONOMIC CONDITIONS

The Farm Sector In Transition

The farm sector is entering the fourth year of transition from the tight supplies and high prices of the 1970's to the large supplies and lagging prices of the 1980's. The transition was touched off by fundamental changes in agricultural supply and demand worldwide and has proven disruptive enough to put a growing number of farm operators under serious financial stress.

Many of the macroeconomic, policy, and weather factors that contributed to the expansionary market of the 1970's have worked in reverse so far in the 1980's. Growth in demand for farm products has averaged less than 1 percent per year in the 1980's compared with 3-4 percent in the 1970's. The sector's capacity to produce has continued to expand 2-3 percent per year in the 1980's, however, as investments made in the 1970's matured and high support rates weakened producer incentives to adjust to the changing market environment.

This growing imbalance between farming's capacity to produce and demand for its products has made the sector increasingly dependent on government price and income support programs to forestall a sharp drop off in farm returns. With a brief respite in 1983/84 due to PIK and the drought, commodity prices have stagnated in nominal terms and fallen more than 20 percent in real terms since 1980. The large stocks accumulated since 1980 suggest prices would have fallen significantly further without the U.S. Government loan program to underpin grain, oilseed, and cotton prices.

Farm income has also stagnated in nominal terms while falling a fifth in real terms. Income would also have fallen in nominal terms and declined further in real terms without increased support via direct government payments—up from \$2 billion per year in the late 1970's to \$7 billion in the 1980's—and indirectly via the loan program. Price and income support program costs have burgeoned more than the direct payment subtotal suggests—from less than \$5 billion per year in the late 1970's to \$14 billion in the 1980's. These price, income, and costs developments contrast sharply with expectations of continued growth in farm returns and low program costs as recently as 1981.

Farm asset values have been under similar pressures but without support programs to mute their impact. The sharpest drops in asset values have been concentrated in real estate, with land values off more than a third in real terms since 1982 as developments in the macroeconomy reinforced developments within the sector.

The financial stress generated by this deterioration in prices, incomes, and assets has varied widely across subsectors within agriculture. While the sector as a whole showed a positive cashflow in 1984, 50 percent of operators did not have sufficient cash income from farm and off-farm sources to meet farm operating costs and family living expenses. While the sector as a whole has lost less than a third of the asset appreciation of the 1970's, almost 20 percent of operators have experienced enough asset erosion to push them into highly leveraged positions or technical insolvency. Roughly 12 percent of farmers concentrated in field crop and livestock operations in the Corn Belt, Lake States, and Northern Plains face serious enough cashflow and asset losses to jeopardize their continued operation.

Prospects for Further Adjustments

Prospects for further deterioration in the farm financial situation depend on developments in the major commodity markets, the macroeconomy, and the farm legislation passed later in the year. Developments in all three areas suggest that farm financial stress is likely to continue, possibly intensify, over the coming year.

The outlook for the major commodity markets is depressed. This year's large beginning stocks, excellent crop prospects, and lagging exports are adding to downward pressure on prices, incomes, and asset values. Without a severe drought comparable to 1983 or a sharp increase in exports comparable to the surges of the 1970's, commodity prices are likely to lag at or below loan levels.

Prospects for the macroeconomy also point to continued financial stress. Most macroeconomic analysts agree that the dollar will continue strong enough to discourage exports while interest rates are unlikely to fall far enough to reduce production expenses or stabilize asset values. Moreover, they also tend to agree that global economic growth will not be fast enough to generate a significant expansion in foreign demand for farm products.

Commodity prices would have to rise 20-30 percent to forestall further declines in incomes and land values. of price supports high enough to prevent further declines, however, would be large -- possibly twice the 1980's \$14 billion per year average. Moreover, this would destroy agriculture's capacity to export, causing even greater problems of excess capacity. This is clearly not a viable alternative. environment, the sector could face continued financial pressure for 2-3 years more until sufficient resources leave the sector to bring agriculture's capacity to produce back into balance with demand for its products. Farm incomes could fall \$2-4 billion further (5 to 10 percent) despite large scale government payments while land values could slip another 10-20 percent. A drop in supports that allowed commodity prices to fall to market-clearing levels could result in even greater losses in farm incomes -possibly \$6-8 billion -- and further drops in land values -possibly 30-40 percent.

Agricultural Lender and Agribusiness Impacts

while operators facing both cash shortfalls and serious asset erosion make up only about 10 percent of farms, they account for more than 45 percent of farm debt. Their increased difficulty servicing this debt has become a serious problem for the farm credit system and agricultural banks. Agricultural lenders have also come under pressure directly as a result of declining asset values, deteriorating loan portfolios, and falling rental returns. These lenders play key roles in their local economies and, with the rural credit and banking system increasingly well integrated, further deterioration could spill over to hurt the broader rural economy in the most seriously affected states.

Farm financial problems are also affecting the rest of the agribusiness complex. Among input industries, machinery has been hardest hit as farmers cut back on purchases. Plant operations have been scaled back in many cases to less than half of capacity. The fertilizer industry is also depressed, with capacity utilization rates lagging in the 72-77 percent area. The transportation, processing and marketing subsectors are also facing an increasingly serious excess capacity problem with 15-20 percent of their plants unused.

PROGRESS ON THE 1985 FARM BILL

In early 1985 the Administration sent to the Congress a farm bill proposal that provided for market orientation by reducing price and income supports and tying them more closely to past movements in market prices. Supply control programs were to be phased out; a five-year transition period was provided to move from current programs to more market-oriented programs. The Administration's proposal would have cut budget outlays significantly while permitting the farm sector to regain export competitiveness by reducing price and income support levels. The proposal was perceived by the agricultural community and the Congress as too austere since the reduced price and income supports would result in a sharp drop in farm income in the short run. The proposal received no serious consideration by Congress and is effectively dead.

The Senate and House agriculture committees have been making up the 1985 Farm Bill for over three months now. Each committee has considered a wide range of proposed approaches to future farm policy. These include:

- o Imposition of mandatory supply controls on farmers;
- o Payment of direct income transfers to farmers while moving rapidly to a market-oriented agriculture;
- o A slower transition to market-orientation while retaining larger income supports than proposed by the Administration;
- o Retention of current price support loan programs, but permitting farmers to repay loans at market prices when they fall below the support levels.

After three months of work neither committee has reported out a farm bill, although both committees hope to report out bills before the August recess. No single approach to future farm policy is dominating the others. In general, the current status can be characterized as follows:

- o Agriculture committee members recognize that current farm programs are pricing U.S. producers out of world markets and that prices must fall to restore international competitiveness.
- o Committee members insist, however, that any new farm legislation must seek to maintain farm income.
- o Committee members acknowledge that getting the budget under control is essential, but they consider this less important than protecting farm income.

The Senate Budget Resolution provides some discipline at the approximately \$32 billion level as calculated by the CBO. (This is equivalent to the Administration's calculation of \$38 billion since we include a loss reserve for CCC export credit guarantees.) The proposals being considered by both committees cost out at over \$50 billion during FY 86-88.

The driving motivation of most Agriculture Committee members is to provide sufficient income transfer to farmers to quiet agricultural interests sufficiently far in advance of the 1986 election to ensure minimum political risk.

The Economic Policy Council recently reviewed the alternative Farm Bill proposals and defined as unacceptable several approaches being considered by Congress:

- o Mandatory supply controls in any form.
- o Marketing loans (which allow a producer to repay his commodity loan at a lower market price) invite large potential budget exposure with no prospect of this exposure declining over time.
- o Failure to adopt a policy that permits market prices to fall in order to restore export competitiveness.
- o Extending current law, which would continue to make us noncompetitive in world markets and accelerate Federal credit exposure because commercial banks would withdraw more rapidly due to long-term uncertainty.
- A dairy price support program embodying a dairy diversion program.

James A. Baker III Chairman Pro Tempore

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